ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Leslie	Analyst:	John Pavalasky	Bill Number:	AB 1591
Related Bills:	See Legislative History	Telephone:	845-4335	Introduced Date:	February 23, 2001
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Qualified Equity Investment in Qualified Community Development Entity Credit

SUMMARY

This bill would allow a credit for investments made in a qualified community development entity (CDE).

PURPOSE OF THE BILL

According to the author's staff the purpose of this bill is to enact a state tax credit that closely conforms to the federal New Markets Tax Credit.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately, however, it specifically provides that it would apply to taxable years beginning on or after January 1, 2002.

POSITION

Pending.

Summary of Suggested Amendments

Technical amendments are necessary and are provided. In addition, substantive amendments are necessary to resolve implementation and policy concerns. Department personnel are available to work with the author to resolve these concerns and any other issues that arise as the bill moves through the legislative process.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

<u>General Description (See Appendix A for a detailed description)</u>

Starting in 2001, federal law allows a new credit called the New Markets Tax Credit. That credit will enable a CDE to raise investment capital from taxpayers. The CDE will then have the capital to make loans to businesses in low-income communities or directly to low-income persons.

Board Position:			Department Director	Date
______ S	______ NA	______ NP		
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______ N	______ OUA	__X__ PENDING		

The New Markets Tax Credit available to the investor that holds the stock in the CDE over a seven-year period is as follows:

- a 5% credit for the first three years after the equity interest is purchased from the CDE, and
- a 6% credit for the following four years.

The maximum annual amount of qualifying equity investments eligible for the credit is capped as follows:

Calendar Year	Maximum Qualifying Equity Investment
2001	$1.0 billion
2002-2003	$1.5 billion per year
2004-2005	$2.0 billion per year
2006-2007	$3.5 billion per year

California law does not conform to the CDE credit. However, under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), California law allows a 20% credit for the amount of each "qualified deposit" into a "community development financial institution" (CDFI).

This CDFI credit will sunset for taxable years beginning on or after January 1, 2002.

See Appendix A for details of this credit

THIS BILL

This bill would allow a credit over a seven-year period to a taxpayer for a percentage of the amount of cash a taxpayer invests in a qualified CDE. The qualified CDE must have as its primary mission serving or providing investment capital for low-income communities or low-income persons located in California. This California credit parallels the federal New Markets Tax Credit except that the CDE must be certified by the state instead of by the U.S. Secretary of the Treasury and the qualified low-income community investments must be made in California to qualify. In addition, low-income communities are defined to only include areas located in California.

The amount of state credit that may be designated as a qualified state credit by a qualified CDE is equal to the allocation that CDE received under the federal new markets allocation for federal purposes. A qualified CDE is required to sell equity interests to investors within five years of the date the entity receives a federal new markets allocation. Any amount not sold within that time period is no longer eligible for the state credit.

If the credit exceeds the tax for the taxable year, the excess may be carried over to reduce the tax in the succeeding years, until the credit is exhausted.

IMPLEMENTATION CONSIDERATIONS

This bill in 17052.77(b)(A)(iii) requires that the entity be certified by the state as being a qualified CDE while in 23677(b)(A)(iii) the certification is required to be done by the State Treasurer. The state agency that currently administers the economic development of low-income communities in California is the Trade and Commerce Agency (TCA). As a result, TCA would seem to be the appropriate state certifying authority for these credits.

In addition, the bill requires recapture of credits claimed by the taxpayer upon disqualifying events occurring within those certified entities. The taxpayer will not know that one of these recapture events has happened within the entity, and the department would be auditing the taxpayer and not the certified entity. The state certifying authority, in addition to the initial certification required by this bill, should also be required to monitor:

- investments made by taxpayers in these certified entities, and
- the occurrence of recapture events inside these entities.

The state certifying authority should be required to notify the department of the taxpayers making qualified equity investments as well as the taxpayers impacted by a recapture event within these certified entities.

Also, the definition of qualified low-income community investments includes financial counseling and other services to residents of, and businesses located in, low-income communities located in this state. The use of the term "other services" without a definition could lead to disagreements between the department and the taxpayer claiming the credit. A definition of this term would enable the state certifying authority to monitor the investments made by the qualified CDE.

This bill requires the qualified CDE to designate that the investment made by the taxpayer qualifies for the credit. The CDE should also be required to report to the state certifying authority and the department the taxpayers making qualified equity investments in the qualified CDE. This notification would enable the taxpayer to claim the credit for the seven-year credit period, absent a recapture event, without the need for an intrusive audit to determine the taxpayer's eligibility for the credit.

The maximum amount that a qualified CDE can designate as qualified credits under this bill cannot exceed an amount equal to the federal New Markets Credit allocated to the qualified CDE under federal law. The state allocation must be used within five years of receiving that federal allocation. CDE should also be required to report to the state certifying authority the date and amount of the federal allocation so that the total state credit available and the time limit can be verified by the state certifying authority.

TECHNICAL CONSIDERATIONS

The term "qualified low-income community investments" is defined in the bill. However, in two instances (once in Section 17052.77(b)(2)(B) and once in Section 23677(b)(2)(B)) part of the phrase was omitted. Amendments 1 and 8 are provided to resolve this issue.

The phrase "in this state" was omitted in two places in the bill (once in Section 17052.77(b)(4)(B) and once in Section 23677(b)(4)(B)). Amendments 2 and 9 are provided to resolve this issue.

In Sections 17052.77(b)(5)(A)(i) and 23677(b)(5)(A)(i), an unnecessary word appears. Amendments 3 and 10 are provided to resolve this issue.

In two instances (once in Section 17052.77(b)(5)(A)(v) and once in Section 23677(b)(5)(A)(v)) a cross-reference to a section in the Internal Revenue Code is incorrect. Amendments 4 and 11 are provided to resolve this issue.

In Sections 17052.77(c)(2) and 23677(c)(2), the periods for the computation of the credit overlap. Amendments 5 and 12 are provided to resolve this issue.

The bill contains two references to federal terminology rather than state terminology. Amendments 6 and 13 are provided to resolve this issue.

In two instances (once in Section 17052.77(f) and once in Section 23677(f)), the term "this subdivision" is used where the term being defined is not in "this subdivision." Amendments 7 and 14 are provided to resolve this issue.

The bill uses language that is similar but not identical to the federal new markets tax credit. In some cases, these differences in language have no substantive legal effect but could nonetheless lead to taxpayer confusion. For example, the federal law identifies eligible entities as corporations and partnerships, while the bill identifies eligible entities as corporations, partnerships, and limited partnerships. While limited partnerships are required to pay an annual California tax of $800, for federal purposes and all other California tax purposes, limited partnerships are treated no differently than entities that are partnerships. However, the identification of limited partnerships as eligible entities could confuse taxpayers into concluding that other entities taxable as partnerships, such as limited liability companies (LLCs), are not eligible entities.

In addition, while attempting to parallel the federal new market credit for qualified investments in California, the bill appears to create some unintended differences. (See Policy discussion below). To the extent consistent with the author's intent, an alternative approach would be to provide a state credit equal to the credit authorized under federal law but limited to qualified investments in the state. Using such an approach eliminates any unintended differences between the federal and state credit.

LEGISLATIVE HISTORY

SB 1084 (Haynes, 2000/2001), currently in the Senate Revenue & Taxation Committee, has provisions identical to this bill.

PROGRAM BACKGROUND

California has four types of economic development areas that are administered by the TCA:

- Enterprise Zones (EZ),
- Local Agency Military Base Recovery Areas (LAMBRA),
- Targeted Tax Area (TTA), and
- Manufacturing Enhancement Areas (MEA)

The following table shows the incentives available to each of the economic development areas.

Types of Incentives	EZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	
Hiring Credit	X	X	X	X
Employee Wage Credit	X			
Business Expense Deduction	X	X	X	
Net Interest Deduction	X			
Net Operating Loss	X	X	X	

OTHER STATES' INFORMATION

*Florida, Illinois, Massachusetts, Michigan, Minnesota***,** and *New York* do not allow a credit comparable to the credit proposed by this bill. However, those states do provide either enterprise zone tax incentives in economically depressed areas or financial incentives (i.e., industrial development bonds, infrastructure loans and grants, venture capital funds, and other community development assistance programs) to promote community development. These states were examined due to similarities between those states and California's population and business activity.

FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

The Department of the Treasury's CDFI Fund hopes to issue a notice of allocation availability by the end of April 2001, which has already passed. The first round of tax credit allocations will likely not occur before December of this year. Allocations of credits are expected to be made every year in a competitive process.

As the proposed tax credit at the state level is linked to the amount of federal allocations to qualified CDEs in California, revenue losses due to the proposed credit are speculative at this time. However, as possible order of magnitude only, assuming a proportional allocation to qualified CDE's in California, revenue losses attributed to the proposed credit (based on prorating federal estimates) would be on the order of $1 million beginning in 2002-03, growing to perhaps $5 million by 2003-04.

This bill would require that a qualified CDE be a "domestic" corporation or partnership. Under California Corporations Code Section 167, a domestic corporation means a corporation formed under the laws of California. A requirement that that a qualified CDE be a "domestic" corporation or partnership may be subject to constitutional challenge under the Commerce Clause of the United States Constitution. Since the investments made by a qualified CDE are required to be made "in this state" in order for a taxpayer to receive a credit under this bill, it could be argued that the requirement that a qualified CDE be a "domestic" corporation or partnership is unnecessary. However, the maximum California credits that can be designated by a qualified CDE are equal to the amount of the credit allocated to the entity under federal law. The author may wish to provide a limitation on the maximum California credits available for designation based on the amount of investments made in California for a qualified CDE making investments both within and outside of California.

ARGUMENTS/POLICY CONCERNS

This bill creates a credit that is claimed by the taxpayer investor in each of seven years beginning with the year of the initial investment. One provision of the bill allows a subsequent investor to qualify for this credit if the investment was a qualified investment to the original investor. However, there are no provisions to prevent the original investor from continuing to take the credit for the full seven years and also have the subsequent investor qualify to claim the credit as well. The comparable federal credit, however, requires that the investment be held on the credit allowance date (i.e. the date the investment is initially made and on each of the six anniversary dates after the date of the initial investment) by the taxpayer in order to claim the credit. The author may wish to specify rules similar to the federal rules for the transfer of eligibility to claim this California credit from the original investor to the subsequent investor so that the credit is claimed by only one investor or the other in each of the seven years beginning with the year of the initial investment.

This credit requires the qualified CDE to invest at least 85% of its aggregate gross assets in qualified low-income community investments, which means they have to be located in California. And the recapture mechanisms insure that this will be met. But how is the 85% test applied in situations where the value of the CDE's investments temporarily decline to below 85%, even though more than 85% were originally invested in CA businesses? (Since these are equity investments, this is not unlikely.) How will the value of these investments be determined?

This bill appears to provide is that a separate business or a segment of the taxpayer which generates nonbusiness income can generate this credit to be used by members of the unitary group to offset the tax due on California-sourced business income. This is in apparent conflict with unitary theory, which segregates different lines of businesses within a unitary group (and even within the same business entity) and which differentiates between business and nonbusiness income.

This bill does not specify a repeal date or limit the number of years for the carryover period. Credits typically are enacted with a repeal date to allow the Legislature to review their effectiveness. However, even if a repeal date were added, the department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits are typically used within eight years of being earned.

LEGISLATIVE STAFF CONTACT

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APPENDIX A

FEDERAL/STATE LAW (DETAILED DESCRIPTION)

For investments made on or after January 1, 2001, Public Law 106-554 includes a provision that creates a new federal tax credit (called the New Markets Tax Credit) for qualified equity investments made to acquire stock in a selected CDE. The maximum annual amount of qualifying equity investments is capped as follows:

Calendar Year	Maximum Qualifying Equity Investment
2001	$1.0 billion
2002-2003	$1.5 billion per year
2004-2005	$2.0 billion per year
2006-2007	$3.5 billion per year

The amount of the New Markets Tax Credit available to the investor that holds the investment in the CDE on the credit allowance date (either the original purchaser or a subsequent holder) is:

(1) a 5% credit for the year in which the equity interest is purchased from the CDE and the first two anniversary dates after the interest is purchased from the CDE, and
(2) a 6% credit on each anniversary date thereafter for the following four years.

The taxpayer's basis in the investment is reduced by the amount of the credit. The credit is subject to the general business credit rules.

A CDE is any domestic corporation or partnership:

(1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons,
(2) that maintains accountability to residents of low-income communities by their representation on any governing board or on any advisory board of the CDE, and
(3) that the U.S. Treasury Department certifies as an eligible CDE.

In allocating the credits, the U.S. Treasury Department gives priority to entities with records of having successfully provided capital or technical assistance to disadvantaged businesses or communities. In addition, it considers entities that intend to invest substantially all of the proceeds from their investors in businesses in which persons unrelated to the CDE hold the majority of the equity interest.

If a CDE fails to sell equity interests to investors up to the amount authorized within five years of the authorization, then the remaining authorization is canceled. The U.S. Treasury Department can authorize another CDE to issue equity interests for the unused portion. No carry over of an unused authorization can be made after 2014.

A "qualified equity investment" is defined as stock or a capital interest in a partnership acquired at its original issue directly from a CDE (or through an underwriter) solely in exchange for cash. Substantially all of the cash must be used by the CDE to make "qualified low income community investments." Qualified low-income community investments include:

(1) capital or equity investments in, or loans to, qualified active businesses located in low-income communities,
(2) certain financial counseling and other services specified in regulations to businesses and residents in low-income communities,
(3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment, or
(4) an equity investment in, or loans to, another CDE.

U.S. Treasury Department regulations will provide guidance with respect to the "substantially all" standard. However, a safe harbor of 85 percent is established. The stock or equity interest cannot be redeemed (or otherwise cashed out) by the CDE for at least seven years. If an entity fails to be a CDE during the seven-year period following the taxpayer's investment, or if the equity interest is redeemed by the issuing CDE during that seven-year period, then any credits claimed with respect to the equity interest are recaptured (with interest) and no further credits are allowed.

A "low-income community" is defined as census tracts with either:

(1) poverty rates of at least 20% (based on the most recent census data), or
(2) median family income that does not exceed 80% of the greater of metropolitan area income or statewide median family income (for a non-metropolitan census tract, 80% of non-metropolitan statewide median family income).

In addition, the U.S. Treasury Secretary may designate any area within any census tract as a "low-income community" provided that:

(1) the boundary of the area is continuous,
(2) the area (if it were a census tract) would satisfy the poverty rate or median income requirements within the targeted area, and
(3) an inadequate access to investment capital exists in the area.

A low-income community can include a possession of the United States (and thus investments in a U.S. possession may qualify for the New Markets Tax Credit).

A "qualified active low-income community business" is defined as a business that satisfies all of the following requirements:

(1) at least 50% of the total gross income of the business is derived from the active conduct of trade or business activities in low-income communities;
(2) a substantial portion of the use of the tangible property of such business is used in low-income communities;
(3) a substantial portion of the services performed for such business by its employees is performed in low-income communities; and
(4) less than 5% of the average aggregate of unadjusted bases of the property of such business is attributable to certain financial property or to collectibles (other than collectibles held for sale to customers).

There is no requirement that employees of the business be residents of the low-income community.

Rental of substantially improved commercial real estate located in a low-income community is a qualified business, regardless of the characteristics of the commercial tenants of the property. The purchase and holding of unimproved real estate is not a qualified active business. In addition, a qualified business does not include (a) any business consisting predominantly of the development or holding of intangibles for sale or license; or (b) operation of any facility described in Internal Revenue Code sec. 144(c)(6)(B). A qualified business can include an organization that is organized on a nonprofit basis.

California law does not conform to the CDE credit. However, under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), California law allows a 20% credit for the amount of each "qualified deposit" into a "community development financial institution" (CDFI).

CDFIs have emerged over the last 20 years to provide opportunities for neglected communities, businesses, and individuals that lack access to traditional sources of financing. There are more than 310 CDFIs in urban, reservation-based, and rural settings in the country, and together they manage $1 billion to provide financing, investments, and extensive development services. CDFIs lend to borrowers who do not satisfy the criteria for conventional lenders.

CDFIs may be banks, credit unions, or non-regulated non-profit institutions organized to gather private capital for community development lending or investing. Some CDFIs focus on a particular community while others lend to certain groups of people (minorities, women, low-income families, and social service providers). All CDFIs are financial intermediaries that have a common mission of community development.

Existing federal law allows a credit equal to 5% of <u>contributions</u>, up to $2 million for each corporate taxpayer, to community development corporations, but <u>not for deposits</u> into a CDFI. Existing state law has not conformed to the federal credit for contributions to a community development corporation.

For purposes of the 20% state credit, a qualified deposit is defined as a deposit that does not earn interest, or an equity investment, that is equal to or greater than $50,000 and is made for a minimum duration of 60 months. A CDFI is defined as a private financial institution located in California and certified by the California Organized Investment Network that has community development as its primary mission and lends in urban, rural, or reservation-based communities in California. A CDFI may include a community development bank, a community development loan fund, a community development credit union, a micro-enterprise fund, a community development corporation-based lender, and a community development venture fund.

California law provides for a recapture of the credit if the qualified deposit is reduced or withdrawn before the end of the 60-month period.

This CDFI credit will sunset for taxable years beginning on or after January 1, 2002.

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FRANCHISE TAX BOARD’S PROPOSED AMENDMENTS TO SB 1084
As Introduced February 23, 2001

AMENDMENT 1

On page 3, line 2, after "low-income" insert:

community

AMENDMENT 2

On page 3, line 29, after "investment" insert:

in this state

AMENDMENT 3

On page 4, line 2, before "derived" strikeout "be"

AMENDMENT 4

On page 4, line 17, after "Section" strikeout "1397(C)(e)" and insert:

1397C(e)

AMENDMENT 5

On page 5, lines 9 & 10, strikeout "following four years after the qualified investment was initially made" and insert:

four years after the period specified in paragraph (1)

AMENDMENT 6

On page 5, line 19, strikeout "chapter" and insert:

part

AMENDMENT 7

On page 5, line 21, strikeout "subdivision" and insert:

section

AMENDMENT 8

On page 6, line 37, after "low-income" insert:

community

AMENDMENT 9

On page 7, line 24, after "investment" insert:

in this state

AMENDMENT 10

On page 7, line 36, before "derived" strikeout "be"

AMENDMENT 11

On page 8, line 11, after "Section" strikeout "1397(C)(e)" and insert:

1397C(e)

AMENDMENT 12

On page 9, lines 3 & 34, strikeout "following four years after the qualified investment was initially made" and insert:

four years after the period specified in paragraph (1)

AMENDMENT 13

On page 9, line 13, strikeout "chapter" and insert:

part

AMENDMENT 14

On page 9, line 15, strikeout "subdivision" and insert:

section